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TORONTO, August 23, 1983: Canadian governments have had great difficulty picking industrial winners and even greater difficulty unloading industrial losers, and a study prepared for the Ontario Economic Council suggests that in future they should avoid making detailed decisions about which firms, technologies, or industries are most likely to succeed. On the other hand, there is a role for government both in creating a favourable investment climate in which winners can emerge on their own and in easing the transition of people now employed in the "sunset" industries.

As part of the Ontario Economic Council's Policy Study Series, McGill University economics professor William G. Watson's PRIMER ON THE ECONOMICS OF INDUSTRIAL POLICY has been written with the layman in mind.

Professor Watson says his goal is to explain why "most economists are leery of industrial policy, especially when it entails the government's trying to expand some industries, sectors, or production techniques at the expense

of others". He contends that "what makes them skeptical is their belief that on its own the market is likely to arrive at an efficient allocation of society's resources to various sectors and industries. And even in those cases where market failure blocks an optimal allocation, many economists worry that government failure will prevent public policy from improving matters and may even make them worse...Even when the market fails outright, it does not automatically follow that government can summon the skill, imagination, and information to do better...To paraphrase Churchill on democracy, the market may be the worst mechanism for allocating resources, except for all the rest."

Professor Watson explains that, for economists, efficiency means using resources where they are demanded most. The virtue of the market, as he sees it, is that it can usually be depended on to accomplish this. This is "the source of the skepticism with which economists customarily greet assertions that an economy's industrial structure is inappropriate. If some industries have over-expanded, they ask, why haven't the inefficient firms gone out of business? And if there are unexploited margins of profitable production in other industries, where are they and why haven't they been exploited? People who are interested in earning profits do not usually keep losing propositions

going. Nor do they hold back when the margin between price and cost promises to be large."

Professor Watson argues that government failure can arise from two sources.

First, "efficiency, as economists define it, may have scant appeal for politicians. Many groups in society can gain a great deal by persuading government to grant them sheltered, monopolized niches or otherwise protect them from the harsh winds of competition. Although the social losses resulting from this sort of behaviour usually exceed the monopolist's gain, they are also usually diffuse, so the hard-done-by cannot easily organize effective political resistance...Much casual evidence suggests that the modern world does work this way. The business section of any good daily newspaper usually includes at least one report on an attempt by some special interest group to extract preferential treatment from one or more governments".

Thus the policies of most Canadian governments aim at protecting obvious losers, like textiles and clothing, the footwear industry, and lately the automobile industry. Professor Watson points out that in relative terms Japan used to have twice as many people as Canada in her textiles

and clothing sector. Now this sector is roughly the same size in both countries. Watson argues that whichever industrial policy option you favour if you're going to have "brave new world" thoughts about competing in world markets, then you've got to make sure you can get out of these old industries.

A second source of government failure is that, as "authority systems" - systems "run according to rules and directives" - governments have "strong thumbs, no fingers". Watson argues that the ability of governments "to develop sophisticated plans and to make rapid, discriminating responses to changing circumstances is limited, so it is probably best not to demand anything very elaborate of them. Distributing pensions is something government is likely to do well; designing an industrial structure is not". The problem, as Watson sees it, is the same that confronts all attempts at centralized planning: "those at the centre can never absorb information quickly enough to make use of all there is...How, for instance, could the federal or any provincial government gather sufficient information to decide which high-technology investments Canada should undertake out of the several hundred that are possible? And how can public mechanisms possibly be designed to filter out false information and make the most effective use of the sound

information that does come through?...The argument that markets are better than governments at rolling with the punches is hardly the most sophisticated intellectual property available. The premium on sophistication falls rapidly, however, once one realizes how difficult it is to do better than roll with the punches".

Professor Watson also worries about the potentially corrosive effects of an active, firm-specific industrial policy on Canadian political life. Allowing governments to give grants to firms on a discretionary basis creates a significant opportunity for corruption. Beyond that it teaches "citizens that the road to success runs directly through the Parliamentary lobbies".

Professor Watson concludes that industrial policies should be confined to establishing an environment from which winners can emerge and also to compensating the victims of economic and/or technological change.

He argues that "although in many cases government itself is the principal impediment to the efficient functioning of markets" it is imperative that goverment strive to "provide a hospitable climate for investment."

This can be done in several ways. "First, government should show as little open hostility to investors as possible. This requirement might be thought too obvious to need spelling out, yet it is possible to point to several recent measures that businesses have construed as overtly hostile...Second, whether government policy is hostile to or supportive of enterprise, it should not be fickle...When policy is changed too often, firms and individuals begin to discount its influence in their planning, and, as a result, it may lose most of its potential usefulness. Even worse, it may become a positive nuisance to corporate planners. The same is likely to be true of policies that undergo lengthy gestation...Third, government must realize that by making clear its interest in supporting and encouraging particular firms or investments it inevitably changes the incentive structure. A potential profit is created for those who spend time and money cultivating the government's sympathy, though their output or productivity does not change. This is blatantly wasteful of resources, in both the short and long runs...A final reason for the government's avoiding detail is that in many cases in which intervention may be warranted, theory justifies <u>only</u> general intervention. The argument, for instance, that investment must be encouraged because people have a natural though inefficient bias against distant returns says not just that

they will not spend enough on high-tech investments, but that investment of all kinds will be under-funded. Similarly, if risk-aversion is considered a problem, it is not just new industries that are likely to require special support. Rather, assistance should be offered to all risk-takers, some of whom may be established operators in the economy's oldest industries..."

"For all these reasons," Watson says, "government should probably do everything possible to avoid making detailed allocative decisions. Economy-wide measures - reductions in the taxation of investments, compensation of one kind or another for risk, general measures to encourage savings - are likely to be more suited to government's particular skills than the high-rolling required by a strategy of trying to pick winners".

Professor Watson argues that efficient adjustment policies are a precondition for virtually any change in industrial policy, whether it be toward the highly interventionist policies recommended, for instance, by the Science Council of Canada, or toward the framework-type policies he favours. "While making compensation programs work presents obvious difficulties, any policy of reliance on market forces must

try to do so. In other societies - Japan's perhaps - a strong sense of community may be all that is needed to manage the often traumatic disruptions caused by economic change. In our own, however, the sense of community often seems tenuous. Explicit measures to help the victims of change are, therefore, likely to be necessary...If losers can block change by using the political system, prospective gainers can clearly serve their own interests by making sure that losers are mollified. Thus, compensating the victims of economic change is oe of those (sadly rare) activities in which what is right is also politic."

On the other hand, Professor Watson is extremely skeptical of many of the high-tech, R&D-intensive strategies that are currently proposed for our manufacturing sector. In fact, he argues that Canadian manufacturing is not doing as badly as most people think. Since 1963, "exports of end products have risen dramatically as a share of GNP, of manufacturing shipments, of total exports, and of manufacturing exports. In fact of sixteen (statistical indicators presented) only two have moved in the 'wrong' direction: manufacturing shipments are down slightly as a share of GNP, and the end products deficit is up slightly as a share of manufacturing shipments. The other fourteen indicators all show dramatic 'improvement'. (The quotation marks are used because most

economists, unlike most laymen, are unwilling to attach normative significance to the level of exports or imports.)"

By the same token, Watson argues that Canada's R&D record is not as bad as many people maintain. "For instance, a standard comparison is of Canada's manufacturing R&D expenditures with the United States'; in the late 1970s, typical numbers were 0.34 per cent and 1.59 per cent of the respective GNPs. This comparison can be misleading, however. When the US figure is adjusted to account for that country's larger manufacturing sector, it falls to 1.17 per cent. When it is adjusted further to account for the fact that Canada specializes more in industries that are not R&D intensive anywhere in the world, the US figure falls to 0.81 per cent. Finally, when the Americans' special interest in guided-missile R&D is taken into consideation, their expenditure on manufacturing R&D falls to only 0.75 per cent of their GNP. Thus, more than half the difference between the two countries' R&D efforts is associated with structural differences between the two economies."

On the question of greater government assistance to R&D, Professor Watson says "it needs to be asked whether Canadian governments can usefully do more for R&D than is already being done...Canada currently provides generous legal

protection to inventors and licensees. Moreover, under the existing tax system, more than two-thirds of every new dollar of R&D expenditures by private firms is eligible to be financed by the federal treasury." In 1981 the federal government announced its intention of raising overall R&D expenditures to 1.5 per cent of GNP. Watson comments: "Why this number should be optimal - indeed, whether there are enough potentially profitable projects to consume this volume of funds - is not explained. The main justification seems to be that other countries spend this amount. One might just as easily contemplate a policy to get every citizens' percentage of body fat to the same level. There certainly is no <u>economic</u> rationale for the government's goal." He adds that should the pressures for stepped-up assistance to innovators "prove politically irresistible, due regard to the possibility of government failure suggests that policy should not be overly elaborate. In particular, general incentives - via tax credits or non-discretionary subsidies - would be preferable to attempts to choose likely winners and losers. The use of refundable tax credits, rather than write-offs, would permit the government to be neutral between (presumably larger) firms with existing cash flows and (presumably smaller) firms just starting out".

On the whole, however, Professor Watson comes down hard on

the logic often used to support high-tech strategies. He points out that the classic argument for supporting research and development is that because it has a large spillover benefit it's not something private agents are likely to do sufficiently on their own. But if there are large spillover benefits then for a small country like Canada to engage in an intensive research and development strategy is essentially an act of foreign aid.

Finally, Professor Watson argues that if the government does adopt an R&D-intensive strategy, it will have to bargain for increased access to the United States market. R&D usually involves significant fixed costs. If these are to be recovered, they will have to be spread over a high volume of sales. Since the Canadian market for most manufactured goods is relatively small, this means exporting, and since the US is the nearest big market, it usually means exporting to the US. But, Watson argues, if Canadian firms are to gain access to US markets, Canadian governments had better think twice about pursuing highly interventionist industrial policies. The reason is that other countries will not take kindly to such policies and are likely to retaliate, probably with protectionist policies of their own. "Like shooting wars, trade wars can easily cause damage that is ultimately many times greater

than what was at stake in the early stages of confrontation...Unfortunately, in any prolonged war of non-tariff barriers, it is not the countries with the small internal markets, such as Canada, that can be expected to prosper..."

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A Primer on the Economics of Industrial Policy, 113 pages, price $4.50, is available at the following outlets:

The Ontario Government Bookstore, 880 Bay Street, Toronto, to those shopping in person. Out-of-town customers may write: Publications Section, Fifth Floor, 880 Bay Street, Toronto, Ontario, M7A 1N8, or telephone 965-6015 (toll-free long distance, 1-800-268-7540; in northwestern Ontario, 0-Zenith 67200). A cheque or money order, payable to the Treasurer of Ontario, must accompany all orders.

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